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SUBJECT: DEPUTY BOI GOVERNOR SAYS ISRAEL POISED FOR STRONG RECOVERY  
WHEN RECESSION ENDS

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Summary  
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¶1. Professor Zvi Eckstein, Deputy Governor of the Bank of Israel and Professor of Economics at Tel Aviv University says that for Israel, the economic crisis is entirely imported. As a consequence, Israel's emergence from its economic downturn will happen only when the U.S. economy turns around since the U.S. is such an important export market for Israel. He thinks that the U.S. is in for a long downturn, which will only begin to ease in the second quarter of 2010. At that point, Israel's good macro-economic fundamentals and export strength will position the Israeli economy to emerge strongly from the crisis. Eckstein expressed great confidence in the leadership of the Obama administration and the ability of its top economic team to lead the U.S. and the world out of the crisis. He also thought it likely that the new government in Israel would continue the fiscally responsible policies of its predecessors. On the issue of Palestinian workers in Israel, Eckstein said that it is important that the costs to Israeli employers of hiring them be equalized to the cost of hiring other foreigners in order to protect the jobs of Israeli Arabs. End Summary.

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As the U.S. Goes...  
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¶2. In a March 3 meeting with the Deputy EconCouns, Eckstein said that Israel's highly important export sector makes it vulnerable to the economic downturn in the U.S. and Europe (primarily the U.S.), although he characterized Israel's economy as "not as vulnerable as the economies of many other countries." He thinks that the economic crisis will take a long time to play itself out in the U.S., and that the Israeli economy will suffer during the entire period as well. Using the words "deep recession" to describe what is unfolding in the U.S. and the rest of the developed world, he called the present financial and economic crisis "the most globalized integrated financial crisis humanity has ever seen," adding that it was both "unexpected" and "amazing." Noting that Israel's economy and banking system are fundamentally sound after numerous reforms and five continuous years of strong growth, he said that the country can nonetheless not escape the impact of the crisis. Its strong export sector made it vulnerable to a recession among its "customers." A recovery in this sector will have to wait until the advanced economies of the west, especially the U.S., begin to recover.

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Pessimistic on Recovery but Confident in U.S. Leadership  
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¶3. Eckstein noted that some officials in the developed world may have hesitated to put out pessimistic forecasts in the run-up to the crisis so as to avoid damaging the psychology of the markets. Similarly, he thinks that those putting out an optimistic scenario

calling for recovery in the third quarter of 2009 may be similarly trying to "protect" the markets. He said that many private forecasters and hedge-fund managers agree with his view that the financial sector will stabilize only in the second quarter of 2010. According to Eckstein, the downturn in the U.S. will have a second leg, and the worst is yet to come for Europe. While highly critical of the European Central Bank's handling of the crisis, and going so far as to say that it is not clear if the EU will emerge from the crisis intact, Eckstein expressed great confidence in the Obama administration and the U.S. economic leadership team. He said that he is on a first name basis with the top U.S. officials and noted particularly Fed Chairman Bernanke's expertise on the causes of the Great Depression.

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Israel in Relatively Good Shape  
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14. Eckstein said that Israel is a "small boat in a stormy sea," in terms of its place in the overall world financial crisis. The country has only become fully integrated into the world economy during the last ten years, and it is only in the last five years that its economy has really become stable. At this point, Eckstein stressed that Israel's economy is fundamentally strong, noting the current account surplus in the balance of payments, low level of foreign debt, relatively reduced debt to GDP ratio, continued inflow of FDI, the strong and stable shekel, the government's responsible fiscal behavior, and the Bank of Israel's credible monetary policy. In comparison with the U.S., he said that the financial sector is quite conservative and the banking sector safe. He was, however, less sanguine about the overall health of the insurance sector.

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Hi-Tech Down but Defense Exports OK  
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15. Eckstein said that demand for exports is down substantially, and that what does sell goes for lower prices. With that, he said that Israel's exports are less affected than those of other countries. Defense exports, which account for 10-15 percent of GDP have not yet been materially affected by the slowdown. Therefore, important companies such as Israel Aircraft Industries, Elbit, and Israel Military Industries, which export about 70 percent of their production, have not been hurt. He also mentioned that Teva Pharmaceuticals, the world's largest generic drug manufacturer and a very large player in the Israeli economy, is well-managed and doing well. High-tech exports generally, which account for almost 50 percent of exports, are down, but are poised to recover quickly when the recession ends due to the constant development of new products in that sector. Eckstein also mentioned the new Intel plant in Kiryat Gat as a major new contributing factor to Israel's basic export strength.

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Unemployment Will Hit Eight Percent in 2009  
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16. Eckstein noted that private consumption is down due to reduced consumer confidence, with decreased expenditures on both durable and non-durable goods. The flip side of this is, however, that Israelis save about 15 percent of their income, which compares very favorably with the U.S. savings rate. Unemployment is increasing, a problem for which Eckstein saw no easy solutions. He noted, however, that the unemployment level started at a much lower level going into this crisis (below six percent) than it did going into the recession in 2001-2002 (about 11 percent). Eckstein expressed the hope that continuing implementation of programs to encourage employment (the "Wisconsin" Plan), and expanding the negative income tax will help deal with the unemployment problem. He also reiterated the need to reduce the number of foreign workers in Israel. Regarding some employers' decision to institute a four day work week to prevent having to lay off workers, Eckstein views it as a stop-gap measure, which will delay, but not ultimately prevent the layoffs. He forecasts unemployment of 8 percent at the end of 2009.

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New Government Will Maintain Fiscal Responsibility  
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17. Eckstein called the choice of the Finance Minister in the new government "crucial." Regardless of who assumes the position, he does not expect a change in the policy of the last few years vis-a-vis controlling expenditures. The difficult financial situation should at least be helpful insofar as it limits how much the government now being formed will be able to pay out to potential coalition partners to encourage them to join the government. Eckstein believes that the present annual expenditure growth ceiling of 1.7 percent can move as high as 2.5 percent without doing much harm, as long as it is lowered again after the crisis passes. Much depends on why the ceiling would be raised. It would send a negative signal if it is raised only for political purposes--for instance, in order to increase child allowances to induce the Ultra-Orthodox Shas party to join the government. If a pattern of seemingly out-of-control increased expenditures develops, that would result in higher debt at higher interest rates and an overall increase of the interest burden on the budget, similar to what happened in 2001-2002 recession.

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Raising Cost of Employing Palestinians in Israel  
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18. In response to a question on the status of a clause in the 2009 budget arrangements bill designed to raise the cost to employers of employing Palestinian workers and bring it in line with the cost of employing other foreigners, Eckstein said that the bill, like the rest of the 2009 budget submitted to the Knesset last year, had not passed. However, he expected the new government to support it. He said that as of 2010/2011, according to a previous government decision, there will not be any legal foreign workers in Israel in the construction industry; they will only be allowed to work in agriculture and in caring for the elderly. About thirty percent of construction work in Israel is done by Israeli Arabs, who earn about NIS 6,000 to NIS 8,000 a month (about USD 1500-2000). Construction workers in the West Bank earn about NIS 2,000 a month (USD 500). Should the legislation ultimately pass in its present form, any extra fees charged to employers to employ Palestinian workers in Israel will be handed over to the Palestinian Authority. He views this as a "tax" to prevent migration from the West Bank into Israel

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and thereby protect the jobs of Israeli Arabs. Should there be real progress in the peace process, Eckstein said he expects the problem of West Bank Palestinians seeking to migrate to Israel in search of work to worsen considerably.

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